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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

No. 1482

BENJAMIN A. STRATMORE and
HELEN STRATMORE,
Plaintiffs-Petitioners,

vs.

UNITED STATES OF AMERICA,
Defendant-Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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Sec. 1254(1) 2

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The taxpayers petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

Opinions Below

The district court rendered an opinion in favor of the taxpayers on October 3, 1968 and judgment was entered on December 11, 1968 (Appendix D, *infra,* pp. 45a-55a).

The opinion of the district court is officially reported at 292 F. Supp. 59. The United States Court of Appeals for the Third Circuit reversed the district court by its decision rendered January 6, 1970. It is not yet officially reported but, unofficially, may be found at 70-1 USTC ¶9157.

Jurisdiction

The judgment of the court of appeals (Appendix B, *infra*, p. 20a) was finally entered on January 29, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Statutes and Regulations Involved

The relevant provisions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix C, *infra*, pp. 22a-25a.

Questions Presented

(a) Whether payment of certain amounts by taxpayers as guarantors of obligations of corporations of which they are officers and stockholders and the inability to recover from such corporations as primary obligors, gave rise to bad debt losses which were proximately related to the taxpayers' separate trade or business of rendering services for pay, so as to constitute fully deductible business bad debts under Section 166(a) and (d) of the Internal Revenue Code of 1954?

(b) In the alternative, if the losses incurred by the taxpayers were not bad debts, whether the payments made by the taxpayers to creditors give rise to losses incurred in a transaction entered into for profit and are deductible under Section 165(c)(2) of the Internal Revenue Code of 1954?

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(c) Whether taxpayers should have an opportunity to present further evidence on the question of motivation because a stipulation which appeared, at the time of trial, to be an adequate substitute for such evidence, was later adjudged by the court of appeals to be inadequate to carry the taxpayers' burden of proof?

Statement

Taxpayers were officers and stockholders of B. B. Rider Corporation (Rider) and General Manufacturing Corp. (General) in 1959 and prior thereto. They had acquired an interest in Rider in 1938 and were instrumental in forming General in 1950. Rider was an authorized General Motors Frigidaire dealership which sold and serviced Frigidaire products in northern New Jersey. General is engaged in the business of manufacturing precision component parts for aircraft engines for major engine manufacturers and certain agencies of the United States Government. General began operations with a capitalization of $50,000. However, because of unforeseen problems and delays, the capital requirements became greater than anticipated.

Taxpayer Benjamin A. Stratmore was president of both Rider and General. Helen Stratmore is his wife and was a full time employee of Rider and General. She was also an officer of both corporations. The primary duties of Benjamin A. Stratmore during the fifteen years prior to the trial of this case have been to secure financing for these corporations to meet their operational needs. After exhausting bank credit, Benjamin A. Stratmore was compelled to borrow money for both corporations from a number of individuals. These persons would ordinarily loan money to either Rider or General, but as security, therefor, would require personal guaranties of the tax-

payers by way of indorsements of primissory notes of the corporations. Taxpayers complied with this requirement when the loans were made and indorsed the notes of said corporations; taxpayers indorsed corporate obligations totaling in excess of $1,000,000 over a period of years. Without the personal indorsements of the taxpayers, these loans could not have been obtained and the corporations would have ceased to function. As a result, the taxpayers would have lost their full time salaried positions with these corporations. Taxpayers gave their indorsements and lent their credit to Rider and General with the expectation that the use of these funds by the corporations would provide them with continued and increased income by way of salary, and also enhance the value of their proprietary interest therein.

In August, 1957, both Rider and General filed voluntary petitions in bankruptcy under Chapter 11 of the Bankruptcy Act. A plan was agreed upon whereby creditors of the corporations were paid twenty-five per cent (25%) of the amounts due them. As a part of the plan, taxpayers agreed not to file any claims against the corporations in the Chapter 11 proceedings. The arrangement was successfully completed and Rider and General were discharged from bankruptcy in December, 1958.

Some creditors, however, who held promissory notes of Rider and General that had been indorsed by taxpayers, sought payment of the balance due thereon from taxpayers by reason of their indorsements on the notes. In an effort to cut their losses, taxpayers entered into agreements with these creditors whereby taxpayers agreed to pay part of th debt owed on the corporate notes in full settlement of their obligations as indorsers or guarantors thereof. In 1959, after the corporations had been discharged from bankruptcy, taxpayers paid these creditors, pursuant to

the agreements, a total of $17,088. In subsequent years, taxpayers have continued to make further payments; the tax treatment of these later years and payments is not directly involved in this case, but is the subject of other litigation, whose extent and outcome may be guided by a decision on the merits in this case.

In their income tax return for 1959, taxpayers treated the $17,088 paid to creditors as a nonbusiness bad debt under Section 166(d) of the Internal Revenue Code of 1954 (Appendix C, *infra*, pp. 22a-23a). As such deductibility was limited to $1,000 under Internal Revenue Code Section 1211(b). (Appendix C, *infra*, pp. 24a-25a). On this basis, taxpayers paid an income tax of $5,904.61 plus interest and penalties of $518.58, or a total of $6,423.19. Thereafter, taxpayers filed an amended income tax return in which they claimed, as fully deductoble under Internal Revenue Code of 1954 Section 165(c)(2) the sum of $17,088 (Appendix C, *infra*, p. 22a). A claim for refund was filed for the taxes and interest paid (Appendix D, *infra*, pp. 30a-35a). No action having been taken on this claim for more than six (6) months after submission, taxpayers brought an action in the district court for refund.

In order to expedite the trial and because there were no disagreements with regard to the relevant facts of this case, the facts were stipulated. Perhaps the most relevant stipulation in regard to this appeal and the courts below was the following stipulation of fact:

> "Plaintiffs gave their indorsements and lent their credit to B. B. Rider Corporation and General Manufacturing Corp. with the expectation that said corporations' use of these funds would provide them with increased receipts by way of salary and en-

hance the value of their proprietary interests in said corporations."

The taxpayers contended in the district court that their losses were fully deductible because incurred in a transaction entered into for profit or in the alternative because they resulted from business bad debts incurred in their trade or business of rendering services for pay and, hence, deductible under Internal Revenue Code of 1954 Section 166. The Government contended that there was no loss incurred in a transaction entered into for profit and that the $17,088 was a contribution to capital rather than a debt or, in the alternative, that the debt was not incurred in a trade or business.

The district court held that there was no loss incurred in a transaction entered into for profit and that the $17,088 payment resulted in a business bad debt loss which was deductible in full, not a contribution to capital or a non-business bad debt.

The court of appeals reversed the district court and held that the stipulated facts, while implying that some motivation for indorsing the notes of the corporations was present to protect and enhance their salaried positions, did not warrant a finding that such action was significantly motivated by the employee factor. Concluding that the taxpayers had failed to sustain their burden of proof, the court of appeals reasoned that the taxpayers were not entitled to a business bad debt deduction under Section 166(a) and (d) of the Internal Revenue Code of 1954. The impression left by the majority decision of the court of appeals was that unless the taxpayers showed, by presentation of evidence, overwhelming evidence of motivation to protect their trade or business, they must fail in their efforts to obtain a business

bad debt under Section 166 of the Internal Revenue Code of 1954. This represents the view of those courts of appeal that subscribe to the "primary motivation" test as opposed to the "significant motivation" test. The court of appeals also held in this case that the taxpayers' payments pursuant to the guarantees were not a loss under Section 165(c)(2) of the Internal Revenue Code of 1954 but rather constituted a loss on a non-business bad debt under Section 166(d) of the Internal Revenue Code of 1954.

After the opinion of the court of appeals was rendered, taxpayers timely filed with the court of appeals a petition for rehearing and to expand the record. By order of the court of appeals, this petition for rehearing and to expand the record was denied on January 29, 1970 (Appendix A, *infra*, p. 21a).

REASONS FOR GRANTING THE WRIT

1. There is a conflict in the United States Courts of Appeal in regard to the meaning of Section 166 of the Internal Revenue Code of 1954.

Section 166(a) and (d) of the Internal Revenue Code of 1954 (Appendix C, *infra*, pp. 22a-23a), provides that an individual taxpayer can deduct a bad debt in full only if it is "created or acquired in connection with, or the loss therefrom is incurred in, the taxpayer's trade or business". The question in this case, as in all such disputes under this section, turns on whether the amount sought to be deducted is a business or non-business bad debt. Resolution of that question turns on whether the payments, or guarantees in the instant case, were "proximately related" to the trade or business of the taxpayer

(Treasury Regulations on Income Tax (1954 Code), Sec. 1.166-5(b)(2), Appendix C, *infra*, pp. 23a-24a); *Whipple* v. *Commissioner*, 373 U.S. 193, 201.

Proximate relation to the taxpayer's trade or business is a question of motivation. It is at that juncture, however, that the United States Courts of Appeal conflict in their interpretation as to what test to apply—*i.e.*, the primary or significant motivation tests.

It is and has been the Government's contention that, in order for a given bad debt loss to be proximately related to a separate business of a stockholder-employee, it is necessary to show that his interest as an employee was the *dominant* or *primary* motivation for making the loan. In other words, the Government takes the words "proximately related" in the Treasury Regulations and "in connection with" in the statute to require more than a showing of a "significant motivation" stemming from the taxpayer's trade or business. *After* oral argument and submission of briefs to the United States Court of Appeals for the Third Circuit in this case, the Seventh Circuit Court of Appeals decided *Niblock* v. *Commissioner*, 417 F. 2d 1185 (7th Cir., 1969), which accepted that position. That holding is contra to *Weddle* v. *Commissioner*, 325 F. 2d. 849 (2d Cir., 1963) which held that a bad debt loss could be deducted in full if the debt was significantly motivated by the taxpayer's trade or business.

The taxpayers, in reliance upon the *Weddle* case, entered into a stipulation at the district court level which they believed satisfied and established such a significant motivation. That stipulation is:

> "Plaintiffs gave their indorsements and lent their credit to B. B. Rider Corporation and General

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> Manufacturing Corp. with the expectation that said corporations' use of these funds would provide them with increased receipts by way of salary and enhance the value of their proprietary interests in said corporations." (Appendix D, *infra*, p. 42a).

This stipulation clearly indicates a desire on the part of the taxpayers to protect their salaried positions (the taxpayers' trade or business) as well as their proprietary interests as shareholders. At least an equal balance between the two motivations is shown, if not a primary emphasis on the first stated—the salary motivation. In such case, the taxpayers contended and still do contend that this shows a "significant" motivation. It is important to take into consideration all the other stipulations of fact. The overall picture is one of two financially troubled closely held corporations which were compelled to file voluntary petitions in bankruptcy. The stock of Rider and General was truly worthless—their liabilities exceeded their assets at the time. Notwithstanding that fact, which the court of appeals chose to ignore, the Court below concluded that the taxpayers had not met their burden of proof on the important question of motivation.

It is noteworthy that the statutory language of Section 166 uses the phrase "in connection with a trade or business of the taxpayer" (Appendix C, *infra*, p. 23a). It is only the Treasury Regulation which uses the word "proximately". The Government and the courts of appeal have gone beyond the meaning of the statutory language in their interpretation of this section of the Internal Revenue Code of 1954. It is submitted that the taxpayers have established that their losses were incurred in connection with their trade or business regardless of which

test, that is primary or significant, is applied. In this case the debts were created or acquired "in connection with" their trade or business (taxpayers' salaried positions). The payment by the taxpayers of the corporations' indebtedness had the result of producing a continued flow of ordinary income (salaries) but as it now stands because of the decision of the court of appeals those payments are not fully deductible against ordinary income, as they should be.

The court of appeals was definitely presented with stipulated facts that revealed at least significant and perhaps primary motivation on the part of the taxpayers to protect their salaried positions. The practical effect of the majority decision is that unless the taxpayer presents overwhelming evidence of his motivation to protect his trade or business which is the primary motivation test—he must fail in his efforts to obtain full deduction as a business bad debt.

Furthermore, it is undeniably difficult to understand the majority's out of hand dismissal of this matter without remanding for additional evidence in the interest of justice. As was pointed out in the taxpayers' petition for rehearing and to expand the record, the evidence was readily available, and this case being a refund case, the Government would not have been harmed by an order for remand. This was the actual position taken by Judge Stahl in a vigorous dissent (Appendix A, *infra,* pp. 8a-19a). One other point should be stressed regarding this question of remand to produce evidence which the court of appeals deems essential. There are subsequent tax years involved concerning the same issues. These tax years may have to be litigated and some guidance at this stage will certainly economize future litigation including any appeals to this

Court. If the year in question in this case can be fully litigated on its merits, there may be no longer any need to resort to further litigation.

In view of the large amounts sought to be deducted in years subsequent to 1959, carryforwards of the capital loss will not do justice for the taxpayers in later years.

Because of the conflict between the United States Courts of Appeal on such an important issue as the clear meaning and interpretation of the bad debt section of of the Internal Revenue Code of 1954 together with the other reason given above, it is respectfully requested that this Court grant the petition for certiorari and reverse and order remand for trial.

2. This case should be remanded to the District Court to permit the taxpayers to vacate or amplify a stipulation inadvisedly and improvidently entered into with the Government and allow them to present evidence in lieu of said stipulation.

The taxpayers entered into the aforementioned stipulation of fact in the belief that it would expedite the trial. The taxpayers acted under the misapprehension that the stipulation satisfied the then existing legal test in this area of the law. The taxpayers had no reason to believe until the decision of the court of appeals was handed down that the stipulation had been mistakenly and inadvisedly entered into with the Government. The only beacon to guide the taxpayers on this difficult question of motivation was *Weddle* v. *Commissioner, supra.* Furthermore, the taxpayers' belief that the stipulation showed the necessary evidence to secure the bad debt deduction was supported by the decision of the district court, where the taxpayers prevailed.

The district court concluded that the taxpayers had met their burden of proof. This is an uncertain area of the law, particularly as it pertains to the burden of providing a "significant" motivation. Significant motivation is a very subjective thing. To what extent must a taxpayer produce proofs? The taxpayers believed that the stipulation provided enough proof to satisfy the test set forth in the *Weddle* case, *supra*. Because the court of appeals decided that the taxpayers did not produce *enough* evidence on this point, in fairness to the taxpayers and in the interest of justice, this Court should remand this case to permit the taxpayers to produce whatever evidence they have in order that this, the fundamental issue of this case, can be decided.

What evidence can be produced? The taxpayers are prepared to produce competent evidence in the district court as to their motivation in indorsing the notes of their corporations. This evidence would be confined to such relevant matters as a comparison of the amounts of the taxpayers' salaries and the value of their stock ownership, the reason for their desire to retain their salaried positions with the corporations, and the past history of the taxpayers' financial dealings and of their employment. The taxpayers can prove that in the two years preceding the Chapter 11 proceedings involving these corporations, corporate liabilities exceeded corporate assets by in excess of $1,000,000. After successfully completing the Chapter 11 arrangement in which the corporate creditors agreed to accept 25¢ on the dollar, the combined liabilities of these corporations exceeded their combined assets by $1,015,106. The outstanding stock of these corporations was worthless because corporate liabilities far exceeded corporate assets. The taxpayers will produce proof of their salaries. All

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of this information is already known to the Government. It actively participated in the Chapter 11 proceedings; therefore, the Government cannot claim surprise and it would not be prejudiced by the introduction of this evidence. This matter, being a suit for refund of taxes already paid, the Government would not be injured by a remand. The taxpayers have not had an opportunity to present this evidence because of the stipulation which, it appeared at the time of trial, would adequately substitute for such evidence. Taxpayers have not really had "their day in court". The substantive issue of this case, whether the taxpayers were motivated sufficiently under either test, has not been decided.

Had the taxpayers realized that the stipulation was inadequate to support their position prior to the appeal of the Government to the court of appeals, the taxpayers would have petitioned the district court asking for such relief. Such a petition would not have been without precedent!

In the dissenting opinion of the court of appeals, Judge Stahl outlines the leading decisions on this subject (Appendix A, *infra*, pp. 8a-19a). These varying United States Courts of Appeal have recognized that they had an obligation as well as the power to relieve counsel of pretrial stipulations where such relief is necessary to prevent manifest injustice. *Central Distributors* v. *M.E.T., Inc.*, 403 F. 2d 943, 946 (5th Cir., 1968); *Maryland Casualty Co.* v. *Rickenbaker*, 446 F. 2d 751 (4th Cir., 1944); and *Laird* v. *Air Carrier Engine Service*, 263 F. 2d 948 (5th Cir., 1959).

The importance of avoiding an injustice greatly outweighs the relatively slight inconvenience to which the parties and the court may have to be subjected if this Court grants the petition of the taxpayers and remands

this case to the district court. *Knight Newspapers* v. *Commissioner,* 143 F. 2d 1007 (6th Cir., 1944); *Boston Edison Co.* v. *Campanella & Cardi Construction Co.,* 272 F. 2d 430 (1st Cir., 1959); and *Aetna Life Insurance Co.* v. *Barnes,* 361 F. 2d 685 (5th Cir., 1966). Moreover, controversy and litigation involving subsequent years for these taxpayers will be reduced.

The taxpayers petitioned the court of appeals for a rehearing and to expand the record. That petition was denied over Judge Stahl's vigorous dissent (Appendix A, *infra,* pp. 8a-19a). If the question of adequacy of the stipulation had been raised in the district court, the taxpayers petition to vacate or amplify it would have been granted. If such remedy was available at that time, why should these taxpayers now be precluded from submitting additional evidence? The question of burden of proof was not raised in this case until the appeal by the Government to the court of appeals. Why should the Government have the benefit of raising the question of burden of proof in the court of appeals and be assured of prevailing there when, if it had raised the question in the district court for the first time, the district court would have allowed the taxpayers to vacate and/or amplify its stipulation of fact by presentation of evidence? The Government has been granted an unexpected windfall by the court of appeals.

Although the stipulation may not have gone far enough to establish the significant motivation necessary to permit them to deduct this payment as a business bad debt, nevertheless, the stipulations imply that such motivation was present. The Government's principal contention was that the primary motivation test was the correct one, not the significant motivation test and that the taxpayers had failed to meet their burden of proof on that issue.

The question of burden of proof was raised on appeal. To preclude the taxpayers from introducing evidence on this question of motivation now is to condone a miscarriage of justice.

CONCLUSION

It is respectfully submitted that the taxpayers' Petition for Certiorari be granted and this matter be remanded to the district court for introduction of further evidence.

Respectfully submitted,

KENNETH T. STATMORE,
Attorney for Plaintiffs-Petitioners.

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 17786

BENJAMIN A. STRATMORE AND
HELEN STRATMORE,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Argued September 30, 1969

Before STALEY, SEITZ AND STAHL, *Circuit Judges.*

OPINION OF THE COURT

(Filed January 6, 1970)

SEITZ, *Circuit Judge.*

Plaintiffs, taxpayers, brought an action in the district court for a refund of income taxes for the year 1959, contending that $17,088.00 they paid as guarantors of the promissory notes of corporations of which they were officers and stockholders was fully deductible either as a loss incurred in a transaction entered into for profit though not connected with a trade or business under section 165(c)(2) of the Internal Revenue Code of 1954, or, alternatively, a bad debt incurred in a trade or business, under section

166(a) and (d). The district court ruled against the taxpayers on the former contention but in favor of them on the latter. Stratmore v. United States, 292 F. Supp. 59 (D. N. J. 1968). The Government appeals.

The case was decided by the district court on a stipulation of facts, which discloses the following. In 1959 and prior thereto the taxpayers, husband and wife, were officers and stockholders of B. B. Rider Corporation (Rider) and General Manufacturing Corporation (General), both functioning business enterprises. They acquired an interest in Rider in 1938 and were instrumental in forming General in 1950. Taxpayer, Benjamin A. Stratmore, was and still is president of both corporations. His primary duties during the past fifteen years have been to secure financing so that the corporations could meet their operational needs.

General commenced operations with a capitalization of $50,000, which it borrowed from Rider. Rider in turn had to borrow the money from certain individuals who would not lend the money directly to General because, at the time, General was without assets. When General's need for capital increased, Benjamin A. Stratmore had to seek additional financing for it.

After exhausting credit with banking institutions, Stratmore was compelled to borrow money for Rider and General from certain individuals. In the typical transaction, these individuals would lend money to one of the corporations but would require the taxpayers to personally guarantee the corporate promissory notes by endorsing them. Without these endorsements the loans could not have been obtained and the corporations would have ceased functioning.

Although the aggregate amount of such loans is not set forth in the stipulation, it is clear that very substantial sums were involved. Furthermore, it was stipulated that taxpayers gave their endorsements and lent their credit to the corporations "with the expectation that said corpo-

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rations' use of these funds would provide them with increased receipts by way of salary and inhance [sic] the value of their proprietary interests in said corporations."

The taxpayers' endorsements were executed prior to August 1957, when Rider and General filed voluntary petitions in bankruptcy seeking reorganization under Chapter XI of the Bankruptcy Act. At the creditors' insistence, taxpayers did not file any claims. A plan of payment was approved whereby 25 per cent of the obligations owing creditors would be paid. The corporations were discharged from bankruptcy in December 1958, and thereafter, certain of the creditors demanded payment of the balance of the corporate debts from taxpayers as guarantors of the corporate notes. Taxpayers agreed to pay part of the debt owed these creditors in full settlement of their obligations as guarantors. We are concerned with the payment made by them in 1959.

On their original tax return for 1959, taxpayers treated the 1959 payment as a non-business bad debt, deductible only as a short-term capital loss. They later filed an amended return claiming that payment was entirely deductible under section 165(c)(2) of the Internal Revenue Code of 1954. In the district court, taxpayers contended that the amount they paid as guarantors of the corporate notes was either (1) a loss in a transaction entered into for profit though not connected with a trade or business, under section 165(c)(2), or (2) a bad debt incurred in a trade or business, under section 166(a) and (d).

We consider first the district court's ruling that the payment constituted a fully deductible business bad debt. Section 166(a) and (d) provide, insofar as here pertinent, that an individual taxpayer can deduct a bad debt in full only if it is created or acquired in connection with, or if the loss therefrom is incurred in, the taxpayer's trade or business. The test applied in resolving the issue of whether a loss is incurred in a trade or business is found in Treasury Regulation § 1.166-5(b)(2):

"For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception [fully deductible] provided by that subparagraph."

See also Whipple v. Commissioner, 373 U. S. 193, 201 (1963).

The Government is willing to assume for purposes of this appeal that the 1959 payment by these taxpayers pursuant to their guarantees gave rise to a bad debt.[1] However, it contends that, contrary to the ruling of the district court and the contention of the taxpayers, the payment was not deductible as a business bad debt because the taxpayers failed to meet their burden of showing facts from which it could be found that the loss was proximately related to their positions as salaried corporate officers, rather than to their interests as investors in the corporation.

The Government does not challenge the proposition that one acting as a salaried corporate executive can be considered to be engaged in a trade or business for purposes of the statute. This then leaves for decision the extremely difficult practical problem as to whether the taxpayers demonstrated factually that their loss as guarantors was proximately related to their business of being corporate officials, or, more concretely, to the retention and enlargement of their salaries.

The Government contends that for a bad debt to be proximately related to the separate trade or business of a stockholder-employee, it is necessary to show that his in-

1 The Government urged in the alternative in the district court that the payment should be treated as a contribution to capital, not a bad debt. The Government states in its brief that it is presently reviewing this position and has determined not to advance it until that review has been completed. For that reason, the Government informs us, it is not raising the contribution to capital issue on this appeal.

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terest as an employee was the primary motivation[2] for guaranteeing the corporate notes. The taxpayers, relying on Weddle v. Commissioner, 325 F.2d 849, 851 (2d Cir. 1963), argue that it only need be a "significant motivation". The district court did not explicitly state what test it was applying. The Government further contends that, in any event, the facts here meet neither test.

We agree with the Government that the taxpayers have not met their burden of showing even a significant motivation. Because of this view we take of the record, we find it unnecessary to decide whether the correct test is one of primary motivation or of significant motivation.

The heart of the district court's factual evaluation is found in the following portion of its opinion:

> "Rider and General would have ceased to function but for the loans obtained for said corporations by plaintiffs. And those loans would not have been made without plaintiffs' guaranty. A cessation of business by the corporations would have resulted in a loss of plaintiffs' salaried positions. It has been stipulated that plaintiffs gave their indorsements and lent their credit to Rider and General with the expectation that the use of the borrowed and guaranteed loans by the corporations would provide plaintiffs 'with increased receipts by way of salary and enhance the value of their proprietary interests in said corporations.' Such motivation is sufficient under the cited cases." 292 F. Supp. at 62-63.

The stipulation clearly shows that a partial motivation for taxpayers' endorsement of the corporate notes was to protect and enhance their proprietary interests, which, of course, is not a basis for treating a loss resulting therefrom as a business bad debt. Certainly, where both proprietary and employee motivation are admittedly present, the extent of the proprietary motivation is most relevant in determin-

2 Niblock v. Commissioner, F.2d , (7th Cir. 1969).

ing whether there was a "significant" employee motivation. Yet, the district court made no finding as to the extent of this proprietary motivation; indeed, on the sparse record, there could be none. For example, there is not even a showing in the record of the extent of taxpayers' stock interests and capital contributions. But even if the district court were free to consider whether there was a significant employee motivation without considering the extent of the proprietary motivation, taxpayers would still have failed to present sufficient facts to carry their burden. The district court appears to have relied heavily on the stipulation that, without the loans guaranteed by taxpayers, taxpayers' salaries, along with the corporations, would have ceased to exist. But since taxpayers did not even provide evidence as to the amounts of their salaries, it was not possible for the district court to evaluate how important the factors of salary maintenance and increase were in their willingness to guarantee the loans.

True it is that the district court inferred from the stipulated facts that a sufficient motivation was present to fulfill the statutory requirement. But the difficulty with its approach, apart from the fact it did not articulate which standard of motivation it was applying, is that while the facts justify an inference that in endorsing the notes the taxpayers were motivated to some extent by a desire to protect and enhance their salaried positions, the facts do not warrant a finding that such action was significantly motivated by the employee factor.

We conclude that the 1959 payment by taxpayers was not a fully deductible business bad debt under section 166 (a) and (d).

Taxpayers argue in the alternative that the guarantees constituted transactions entered into for profit within the meaning of section 165(c)(2) of the Internal Revenue Code of 1954, and that the payments pursuant to these guarantees resulted in losses rather than bad debts.

In Putnam v. Commissioner, 352 U. S. 82 (1956), the Supreme Court held that the loss sustained by a guarantor

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unable to recover from the debtor is by its very nature a loss from a bad debt to which the guarantor becomes subrogated upon discharging his liability as guarantor. The Court went on to decide that such a loss must be regarded as a bad debt loss, deductible as such or not at all.

The taxpayers would distinguish Putnam v. Commissioner. They assert that under New Jersey law a guarantor cannot be subrogated to the rights of a creditor until the claim of the creditor against the debtor has been paid in full. They argue that since they settled their liability on the guarantees for less than the full amount due, they never became subrogated to the rights of the creditors. Because, say taxpayers, they were not subrogated to the creditors' rights, there was no "debt" which could "become worthless" in their hands. Therefore, they argue, their loss must fall under section 165(c)(2) as a transaction entered into for profit, though not connected with a trade or business, since it cannot be a bad debt under section 166.

The Government does not challenge taxpayers' contention that as a matter of state law there was no subrogation here because taxpayers settled with the creditors and paid less than the full amount due on the guarantees. Rather, it contends that bad debts within section 166 include not only debts created by direct loans, but by an indirect endorsement or other type of arrangement which creates secondary or primary liability on the part of a corporate stockholder, whether or not the stockholder has under state law the right of subrogation following payment.

We are by no means certain that taxpayers' state law position is sound where, as here, the creditors' claims against the debtor had been totally extinguished by the approval of the Plan of Reorganization prior to the taxpayers' payment to the creditors. But we think that the essence of Putnam is the view of the Court of the Congressional purpose behind section 166(c) and the part it was intended to play in the statutory scheme for a common tax treatment of all losses suffered by a corporate stockholder in providing his corporation with financing: these losses are to be treated as capital losses. As the Court

pointed out in Putnam, "There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same . . ." 352 U. S. at 92-93.

It is not meaningful to emphasize unduly the common law principle of subrogation in analyzing the substantial realities upon which federal taxation is based. When the creditor turns to the guarantor for payment, the debt is already uncollectible. In both Putnam and the present case the claims against the debtors were at all relevant times no more collectible in the hands of the guarantors than in those of the original lender. To allow the tax result to turn on the presence or absence of this technical right of subrogation under state law would be to undermine the Putnam doctrine: taxpayers could change capital losses to ordinary losses almost at will. For example, every guarantor could obtain an ordinary loss simply by reaching an agreement with the creditor for payment of less than the full amount of the guarantor's liability, and thus avoiding any subrogation. We hold that taxpayers' payment pursuant to the guarantees was not a loss under section 165(c)(2) but rather a non-business bad debt under section 166(d).

The judgment of the district court will be reversed.

STAHL, *Circuit Judge*, dissenting

While I agree with the majority that the decision of the district court should not be affirmed, I must dissent from the outright holding that the taxpayers are not entitled to a business bad debt deduction under § 166 of the Internal Revenue Code.[1] As discussed later, I believe appellees should be afforded an opportunity to be relieved of a stipulation clearly insufficient and improvident.

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1 I am in accord with the alternate holding of the majority that the amounts appellees were compelled to pay in satisfaction of their guarantees are not deductible under § 165 as a loss incurred in a transaction entered into for profit.

According to the Treasury Regulations,[2] a full deduction based on a loss from a bad debt is proper only where the loss is *proximately* related to a trade or business of the taxpayer. Therefore, where a bad debt loss is suffered by an individual in the course of his economic activity, two key issues arise in determining deductibility:

(1) Was the taxpayer engaged in a trade or business at the time of the loss; and

(2) Was the specific activity which gave rise to the bad debt loss part of the trade or business?

The resolution of each issue may depend to some extent on the taxpayer's motivation, but care should be taken not to confuse the two.[3] The question of proximate relationship arises only in connection with the latter. As pointed out in the majority opinion, it is not contested

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2 The Regulations provide, in pertinent part, as follows:

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. . . . 26 C. F. R. § 1.166-5(b).

The applicable statutory provision of the Internal Revenue Code does not itself establish the "proximate relation" test but rather refers to debts created "in connection with" and losses "incurred in" the taxpayer's business. See note 4 *infra*.

3 In Imbesi v. Commissioner, 361 F.2d 640 (3d Cir. 1966), a case involving the deductibility of a loss under § 165(c)(1), referred to in the Regulations set forth in note 2 *supra*, this court said:

[T]he primary intent or motive of the taxpayer has always been the ultimate test for determining whether losses are deductible because incurred in a trade or business or in transactions for profit, or on the other hand are not deductible because they are personal expenses. 361 F.2d at 644.

However, the *Imbesi* case and the quoted language dealt only with the first of the issues mentioned in the text, *i.e.*, whether the activities of the taxpayer in dispute, the breeding, training and exhibition of dogs and the breeding, training and racing of horses, constituted a trade or business or a personal hobby. In the instant appeal, it is conceded that appellees were engaged in a trade or business. At issue is whether the guaranteeing of the notes was sufficiently related to their trade or business to permit the deduction.

here that the taxpayers' activities as paid officers of the corporations in which they held stock amounted to a trade or business. The only issue, therefore, is whether their guarantees of loans to the corporations were part of or were proximately related to that business.

As indicated in the majority opinion, this case was decided below on a stipulation of fact which established that appellee-taxpayers acted both to enhance their investment and to preserve their salaries in their employment as corporate officers. The district court concluded that since the stipulation showed that trade or business considerations did enter into the decision of the taxpayers to guarantee the loans, there was a sufficient relationship between the subsequent loss and the taxpayers' trade or business to warrant the bad debt deduction.

The Government has argued here that the district court's conclusion was erroneous on either of two grounds.

Primary Motivation

First the Government asserts that where an obligation resulting in a bad debt loss is entered into pursuant to both business and investment considerations, a taxpayer is not entitled to a business bad debt deduction under § 166[4]

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4 The relevant parts of § 166 provide as follows:

Sec. 166. BAD DEBTS.

(a) General rule.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * *

(d) Nonbusiness debts.—

(1) General Rule.—In the case of a taxpayer other than a corporation—

(A) [subsection (a)] shall not apply to any nonbusiness debt;

* * *

(2) Nonbusiness debt defined.—For purposes of paragraph 1, the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) *in connection with a* trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is *incurred in* the taxpayer's trade or business. (Emphasis added.) 26 U. S. C. § 166.

unless he proves that the business motivation was in fact primary. It argues that since the stipulation on which the case was tried shows only that the two motivations, *i.e.*, the preservation of employment and enhancement of investment, were present in unspecified degrees, the taxpayers have not met their burden and have not proved that they were entitled to the full deductibility of their loss under § 166.

I would reject this argument as I do not believe that the language of either the statute or the regulations, which collectively refer to debts "in connection with," "incurred in" and in "proximate" relation to the taxpayers' business, can fairly be said to require that the taxpayers show a primary or dominant business or employment motivation.[5] The import of the language is that both business or employment *and* investment motivations may be present in a transaction without the one negating the connection of the transaction with the other, and consequently that the taxpayer need show only a *significant* rather than a *primary* business motivation in order to deduct a business bad debt.[6]

Language used by the Supreme Court in the leading case in this area, Whipple v. Commissioner, 373 U. S. 193

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5 *See* Weddle v. Commissioner, 325 F.2d 849, 851 (2d Cir. 1963), discussed *infra* at note 9 and the text thereto.

6 In Note, *Shareholder-Creditor Bad Debts Under Section 166 of the Internal Revenue Code*, 75 Harv. L. Rev. 589, 601 (1962), it is stated:

> It would certainly seem that loans should be considered sufficiently proximate when necessary to assure the continued operation of the corporation. The loan is no less a condition of the taxpayer's continuing in his business of rendering services when voluntarily made to keep the corporation by which he is employed from shutting down than when made to avoid being fired by the corporation's management [footnote omitted; see Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961)]. While the question of proximate relationship in such cases might be resolved by seeking to determine whether the taxpayer's primary motivation in making the loan is to maintain his personal business or to protect his investment . . . , any effort to distinguish such motives seems fruitless when the shareholder's personal business is so inextricably intertwined with his investment in the corporation. Inevitably the taxpayer will desire to protect both his investment and his employment without making any distinction between the two; and neither the Code nor the Regulations precludes a determination that the existence of a motive to maintain personal employment is sufficient to justify "business" debt treatment, even though other motives are also present. . . .

(1963), supports this view. Upon examination of the legislative history of the bad debt provision of the Code, the Court concluded that the predecessor to § 166 "was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business. . . ." 373 U. S. at 201. Without discussing whether such a proximate connection existed in that case, the Court there held that the taxpayer was not entitled to a business bad debt deduction for losses on loans made to a soft drink corporation which he had promoted because his activity did not amount to a trade or business.

Here, of course, the only question is whether there was a "proximate connection" between the appellee-taxpayers' guarantees and their acknowledged trade or business as officers of the corporations to which the loans were made. Speaking of situations in which a taxpayer is engaged in a trade or business unlike the case before it, the Supreme Court went on to say in *Whipple* that where "the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from *activities peculiar to an investor* concerned with, and participating in, the conduct of the corporate business." 373 U. S. at 202. (Emphasis added.)

Thus, it would seem that a taxpayer having both business and investment motivations should be entitled to a business bad debt deduction for losses arising out of transactions which are not "peculiar to" or closely identified with investment. This standard is undoubtedly met where the taxpayer shows that the transaction generating the loss was significantly motivated by business considerations. In no way does it appear that in such a situation the statute and the regulations require that the establishment of a proximate connection should depend on a showing that the transaction leading to the loss was *primarily* motivated by the trade or business.

Our attention has been called to only one case in which a court of appeals has held squarely that § 166 demands the application of the primary motivation test. Niblock v. Commissioner, F.2d (7th Cir. 1969).[7] Even in this case the court does not seem to have directly applied the rule which it articulated. After examining the evidence, the court concluded that the loss had *no* relationship to the taxpayer's employment and, in fact, resulted from guarantees "made to build up the value of the stock of the corporation." F.2d at . The approach in *Niblock* was in effect quite similar to that of the many cases where corporate officer-stockholders have argued that bad debt losses were suffered in the course of their trade or business.

In cases under § 166, the courts have usually examined the evidence in support of a proximate connection with a trade or business, without indicating whether the primary or the significant motivation standard was applicable.[8] On the other hand, one court of appeals has expressly rejected the primary motivation test and has held that a taxpayer is entitled to a business bad debt deduction if he was at least significantly motivated by trade or business interests in entering into the transaction leading to the loss. Weddle

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7 The court said in *Niblock:*

In order for taxpayer to obtain a deduction for a business bad debt, he must prove that his corporate employment furnished the dominant and primary motivation for making the advances and the guarantees. We disagree with the significant motivating factor test that was applied by the majority in . . . [*Weddle*]. We believe that the only test that will *inject sufficient certainty* into the interpretation of Section 166, *supra*, is the dominant and primary motivation test that we have stated. F.2d at . (Emphasis added.)

While certainty is to be devoutly sought in the interpretation of the tax laws, we should not sacrifice fairness to the taxpayer in order to achieve certainty. The significant motivation test, while more flexible, presents no insurmountable difficulties in application. More importantly, nothing in the statute or the regulations appears to compel adoption of the primary motivation rule.

8 See, *e.g.*, Spillers v. Commissioner, 407 F.2d 530, 534 (5th Cir. 1969); United States v. Worrell, 398 F.2d 427 (5th Cir. 1968); Lundgren v. Commissioner, 376 F.2d 623 (9th Cir. 1967) (by its citation of Weddle v. Commissioner, note 9 *infra* and text thereto, the court may have been indicating approval of the significant motivation rule); Kelly v. Patterson, 331 F.2d 753 (5th Cir. 1964). See generally Annot., *Federal Income Tax: Stockholder's loan to corporation as basis for business bad debt deduction*, 25 A. L. R. 2d 633 (1952).

v. Commissioner, 325 F.2d 849 (2d Cir. 1963).[9] This is the test I would follow.

Sufficiency of Evidence to Support Significant Motivation Test.

The Government's second argument is that there was insufficient evidence for the court below to sustain the allowance of a deduction even under the significant motivation approach. While the majority does not decide whether the primary or significant motivation standard is to be applied, it concludes that the Government's argument that the proof meets neither standard is meritorious. To this extent I am in agreement with the majority but, in my view, this does not end the matter.

The stipulation before the district court was insufficient to establish a proximate connection between the bad debt loss and the taxpayers' business as corporate officers because it shows only that the business *may have been* a significant motivation. The stipulation leaves open the possibility that it was not.

Any taxpayer owning stock in a corporation by which he is employed can probably claim to have entered a transaction like that in this case with the benefit to his employment status in mind. In order to obtain the full deduction, however, the taxpayer must reasonably show that the business considerations were more than incidental, *i.e.*, he must produce evidence negating the possibility that investment considerations were so important that the transaction

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9 *Weddle* was decided after the Supreme Court's treatment of §166 in Whipple v. Commissioner, *supra*.

In the opinion below, Judge Augelli described *Weddle* as expressing the "view that the necessary proximate relation might be established even where the primary motivating cause for the loan having been made was from the standpoint of a stockholder-investor, if there was a significant secondary motivation related to the trade or business of being an employee." 292 F. Supp. at 63.

See also Millsap v. Commissioner, 387 F.2d 420 (8th Cir. 1968), agreeing with the Tax Court's application of the significant motivation standard in denying a bad debt deduction, and Decker v. United States, 244 F. Supp. 31, 37 (N.D. Io. 1965).

would have been undertaken even had the business considerations been entirely absent. Failing such a showing, the court cannot conclude that the taxpayers' activity was not peculiar to investment purposes.

Without indicating all of the factors that would govern this case under the significant motivation standard, it can be noted that among the relevant elements would be a comparison of the amount of the taxpayers' salaries and the value of their stock ownership, the reason for their desire to retain their positions with the corporations, and the past history of the taxpayers' financial dealings and of their employment. Without such evidence, the decision of the district court cannot be sustained.

My disagreement with the majority stems from my belief that although the stipulation did not sufficiently establish the significant business motivation necessary to permit the taxpayers to deduct their losses as a business bad debt, we should not hold on the present record that they are completely barred from claiming the deduction.

A stipulation is entered into by parties for their mutual convenience and to expedite the disposition of litigation, and should not be given any greater effect than that intended. In this case I believe the taxpayers entered into the stipulation under the misapprehension that it sufficiently showed the evidence necessary to secure the deduction. If there had been no stipulation, it is highly probable that evidence of the kind necessary to support a full deduction by the taxpayer, at least under the significant motivation test, would have been brought out at trial.

In the present state of the record, for instance, we do not even know the exact amount of the taxpayers' salaries and the size of their stock holdings. Certainly, probative evidence of this nature on the issue of motivation would have been developed at a trial. Thus the stipulation, if given conclusive effect, is a windfall to the Government because it prevents the taxpayers from adducing the evidence necessary to try to justify their claim.

I believe the courts have the discretion to relieve parties from insufficient, improvident and inept stipulations where to do so would prevent injustice.[10]

In Knight Newspapers v. Commissioner, 143 F.2d 1007 (6th Cir. 1944), a deficiency was assessed against a corporation, a holding company, for failure to include in income a dividend paid by an affiliate. The taxpayer argued that the dividend was not income because its distribution was illegal and was subsequently rescinded. The case was tried on a stipulation before the Tax Court. That court held that the taxpayer had failed to meet its burden of proof because the evidence in the stipulation on the illegality of the dividend was not sufficiently dependable. The taxpayer's motion for rehearing, based on the contention that the inadequacy of the stipulation was due to oversight, was denied by the Tax Court. Holding that the Tax Court had erred, the court of appeals observed that "[t]he exercise of sound discretion would seem to require that the court permit the taxpayer to establish facts which the parties to the litigation had, in good faith, considered covered by a stipulation." 143 F.2d at 1009. The case was remanded for the taking of further evidence.

Boston Edison Co. v. Campanella & Cardi Construction Co., 272 F.2d 430 (1st Cir. 1959), was a case in which a possible misunderstanding of the law led the parties to try the lawsuit on an inadequate stipulation of fact. Boston Edison, a utility company, held an easement over land adjacent to a tract condemned by the state of Massachusetts for construction of a highway. Two of the utility company's poles were damaged when the weight of an embankment built by a contractor caused the ground surface of the adjoining property to shift. The trial court dismissed the utility company's

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10 *Cf.* Central Distributors Inc. v. M. E. T., Inc., 403 F.2d 943, 946 (5th Cir. 1968); Mitchell v. C. & P. Shoe Corp., 286 F.2d 109, 114 (5th Cir. 1960); Maryland Casualty Co. v. Rickenbaker, 146 F.2d 751, 753 (4th Cir. 1944); Bradford v. Schmucker, 135 F.2d 991, 996 (10th Cir. 1943); Snyder v. Drave Corp., 6 F. R. D. 546, 551 (W.D. Pa. 1947). See generally Annot., 161 A. L. R. 1161 (1946).

suit on the ground that legislation protected the contractor and limited the utility company to a remedy against the state.

The court of appeals held that the law protected the contractor only from liability for injuries to property necessarily incident to and unavoidable in the performance of his contract, and that the stipulation was insufficient to permit a finding on the issue. The court went on to say:

> While it might be possible by application of rules of burden of proof and burden of going forward with evidence to reach some kind of a decision on the present record, we do not feel that this would ensure a just result [Footnote omitted.] In clear instances a court has power to relieve parties of a stipulation entered into under a misapprehension of law, . . . just as a new trial may be granted to prevent a miscarriage of justice. We accordingly remand the case to the district court to consider permitting the parties to vacate or amplify their stipulation or to take such other steps as the court may approve. 272 F.2d at 433-434.

A similar result was reached in Aetna Life Insurance Co. v. Barnes, 361 F.2d 685 (5th Cir. 1966). There the trial court had erroneously allowed recovery on a theory clearly barred by a group disability insurance policy. However, there was a possibility of recovery on a different basis which had been overlooked by the plaintiff. As the stipulation upon which the case was tried was insufficient to support a conclusion on the applicability of the alternate theory, the court remanded the case for consideration of whether justice required that the plaintiff be afforded an opportunity to withdraw from the stipulation and present further evidence.[11]

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11 The court said:
Of course it is not for us to remake the record or to reject that which the parties by their formal stipulation have proffered to the trial, and now to this Court. But since these policy provisions have such an immediate and perhaps decisive impact, we think that in the administration of justice, . . .

In Brast v. Winding Gulf Colliery Co., 94 F.2d 179 (4th Cir. 1938), a tax case in which a taxpayer was permitted to withdraw from a damaging stipulation, the court said:

> Where facts subsequently developed show, with respect to a particular matter, that a stipulation was inadvertently signed, the party may be relieved where there is no prejudice to the opposite party. 94 F.2d at 181.

And further:

> The government collected taxes which it had no right to collect. . . . By this action [relieving the taxpayer from the stipulation] the government suffered no prejudice. It was only required to refund the sum it had collected, which it had no right to collect. 94 F.2d at 182.

Likewise in the present case, if the taxpayers were ultimately able to support their claim under § 166, the Government would suffer no legal prejudice if it were required to allow the bad debt deduction.

It appears that inadequacy of the stipulation here, like that in *Boston Edison*, was due to a misapprehension of the legal elements of proof of the taxpayers' claim.[12] Therefore, I would remand to the district court for consideration of whether the interests of justice require the court to exercise its discretion to relieve the taxpayers of the stipu-

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11 (cont'd)

the reversal of the judgment on the theories directly presented should not prejudice the right of the Employee to pursue this theory on remand. Especially is this so since the stipulated facts as to the critical element of termination of employment (and hence insurance) are stated in conclusory, not evidential, factual terms. 361 F.2d at 690.

12 Such misapprehension may be understandable in view of the uncertain case law in this area. As has been observed in a somewhat different context, a taxpayer may be relieved of the effect of a stipulation "entered into under a mistake of law induced by the then existing state of the case law . . . if no prejudice results." Logan Lumber Co. v. Commissioner, 365 F.2d 846, 855 (5th Cir. 1966).

lation and to allow presentation of further evidence.[13] To repeat, I would do so on the basis that even if appellees cannot come within the primary motivation test, the proper rule to follow in determining the allowance of a business bad debt deduction under § 166 is whether there is a significant motivation. To that end appellees may be entitled to the opportunity to offer proof that they come within what I conceive to be the correct test.

13 Of course appellees would be required to submit a petition to the district court asking for such relief and alleging grounds for relieving them of the stipulation. See Morse Boulger Destructor Co. v. Camden Fibre Mills, 239 F.2d 382 (3d Cir. 1956). It is understandable that taxpayers have not acted before as they prevailed below. Furthermore, from my examination of the briefs of the parties submitted in the lower court it appears that the adequacy of the stipulation to support a deduction under the significant motivation theory was not before the district court.

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Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 17,786

BENJAMIN A. STRATMORE and HELEN STRATMORE

vs.

UNITED STATES OF AMERICA,

Appellant

(D. C. Civil Action No. 851-65)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Present:

STALEY, SEITZ and STAHL, *Circuit Judges*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the District of New Jersey and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, filed December 10, 1968, be, and the same is hereby reversed.

ATTEST:

THOMAS F. QUINN
Clerk

January 6, 1970

Certified as a true copy and issued in lieu of a formal mandate on Februry 6, 1970.

Test:

THOMAS F. QUINN
Clerk, United States Court of Appeals
for the Third Circuit

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Appendix B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 17,786

BENJAMIN A. STRATMORE and HELEN STRATMORE
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellant.

SUR PETITION FOR REHEARING

Present:

HASTIE, *Chief Judge*, STALEY, FREEDMAN, SEITZ, VAN DUSEN, ALDISERT, STAHL, ADAMS and GIBBONS, *Circuit Judges*.

The petition for rehearing filed by plaintiffs-appellees in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

/s/ COLLINS J. SEITZ
Judge

Dated: January 29, 1970

APPENDIX C

Internal Revenue Code of 1954:

SEC. 165. Losses.

(a) *General Rule.*

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

• • •

(c) *Limitation on Losses of Individuals.*

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;

(26 U.S.C. 1964 ed., Sec. 165.)

SEC. 166. Bad Debts.

(a) *General Rule.*

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

• • •

(d) *Nonbusiness Debts.*

(1) *General Rule.*—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting

therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) (as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 86-866, 72 Stat. 1606)

Nonbusiness debt defined.—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

• • •

(26 U.S.C. 1964, ed., Sec. 166.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.166-5. *Nonbusiness debts.*

• • •

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

Appendix C

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the charatcer of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is *a proximate one* in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a non-business debt does not include a debt described in section 165(g)(2)(C). See Sec. 1.165-5, relating to losses on worthless securities.

• • •

(26 C.F.R., Sec. 1.166-5.)

Appendix C

SEC. 1211. Limitation On Capital Losses.

• • •

(b) *Other Taxpayers.*—In the case of a taxpayer other than a corporation, losses from sales or exchangs of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller. For purposes of this subsection, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. If the taxpayer elects to pay the optional tax imposed by section 3, "taxable income" as used in this subsection shall be read as "adjusted gross income".
(26 U.S.C. 1964 ed., Sec. 1211.)

APPENDIX D

DOCKET ENTRIES.

Civil 861-65 Docket — Judge Augelli

BENJAMIN A. STRATMORE AND HELEN STRATMORE, Plaintiffs,

vs.

UNITED STATES OF AMERICA, Defendant.

For Plaintiff: KENNETH T. STATMORE, Esq., 663 Main Ave., Passaic.

For Defendant: U. S. Attorney, Newark.

8-5-65 Complaint and demand for jury filed 8-4-65.

8-5-65 Summons issued.

8-5-65 Notice of Allocation and Assignment filed. (Newark-Augelli)

8-11-65 Summons returned served on U. S. Attorney on 8-6-65; served on Attorney General on 8-9-65 filed.

10-5-65 Answer, and Demand for Jury, filed 10-4-65.

11-8-65 Defendant's notice to take depositions of Benjamin A. Stratmore, filed 11-5-65.

9-23-66 Deposition of Benjamin A. Stratmore, taken April 12, 1966, filed 9-22-66.

9-28-66 Pre-trial Conference. (Augelli) (9-27-66) Ordered action removed from jury calendar to non-jury calendar.

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10-10-66 Pre-trial order and removing action from jury calendar to non-jury calendar, filed 10-7-66 (Augelli) Notice mailed.

12-66-66 Stipulation of Facts, filed 12-15-66.

1-5-67 At call for trial, counsel reported action to be submitted on stipulation of facts. (Augelli) (1-3-67)

10-4-68 Opinion, filed 10-3-68. (Augelli) (In favor of plaintiff)

(Copy forwarded to U. S. Attorney General, Washington, D. C.)

12-11-68 Judgment for $6,574.64 in favor of plaintiffs, Benjamin A. Stratmore and Helen Stratmore and against the defendant, United States of America, without costs filed 12-10-68. (Augelli) Notice mailed.

2-6-69 Notice of appeal, filed 2-4-69.

2-6-69 Copies forwarded to Clerk, U. S. C. A. and to Kenneth T. Statmore, Esq.

3-3-69 Record on Appeal forwarded to Clerk, U. S. C. A.

COMPLAINT AND JURY DEMAND.

(Original Filed August 4, 1965.)

Benjamin A. Stratmore and Helen Stratmore, his wife, by their attorney, Kenneth T. Statmore, Esq., complain of the defendant, United States of America, and respectfully allege as follows:

1. We reside at 441 Passaic Avenue, Passaic, Passaic County, New Jersey.

2. This is a civil action to recover moneys alleged by plaintiffs to have been paid in error and illegally collected by the District Director of Internal Revenue for the District of New Jersey at Newark, New Jersey as income taxes for the calendar year 1959. Said taxes were imposed and collected under the Internal Revenue Code of 1954, a statute enacted by the Congress of the United States and in force and effect.

3. The plaintiffs are officers and stockholders of B. B. Rider Corporation and General Manufacturing Corp., a subsidiary, both corporations incorporated under the laws of the State of New Jersey.

4. The plaintiff, Benjamin A. Stratmore, was president of said corporations. His duties were primarily financial and consisted of the responsibility of raising capital to meet corporate obligations. In order for Benjamin A. Stratmore to obtain the necessary working capital for these corporations, plaintiffs were required to personally endorse the promissory notes of said corporations.

5. In August, 1957, B. B. Rider Corporation and General Manufacturing Corp. filed voluntary petitions in bankruptcy. As a result thereof, plaintiffs were called upon by corporate creditors to pay the difference between what was obtainable from the corporation estates and what was owed. Plaintiffs entered into agreements with corporate creditors under which the creditors agreed to take less than what plaintiffs were legally liable to pay. These transactions were entered into specifically for the purpose of cutting plaintiffs' losses.

6. Plaintiffs paid their income tax for the calendar year 1959 to the District Director in installments. The last installment was paid in January, 1964. The District Director of Internal Revenue assessed interest penalties in the total amount of $518.58.

7. On or about February 26, 1964, plaintiffs duly filed with the District Director of Internal Revenue of New Jersey at Newark, New Jersey, in accordance with applicable statutes of the United States of America, a claim for refund of income taxes paid thereon in the aggregate amount of $5,904.61 together with interest penalties in the sum of $518.58 or such larger amounts as were legally determined to be due, plus statutory interest thereon. A copy of said claim is attached hereto and made a part hereof as if set forth herein and marked Exhibit "A".

8. Plaintiffs claim for refund and plaintiffs claim for relief in the present action are based on the following ground:

(a) The plaintiffs' losses as guarantors of said corporate obligations should be treated as transactions entered into for profit though not connected with a trade or business under Section 165(c)(2) of the Internal Revenue Code of 1954.

9. More than six months have elapsed since said amended claim was filed as aforesaid. The Commissioner of Internal Revenue and the District Director for the District of New Jersey have not rendered any disposition with respect to said claim.

WHEREFORE, plaintiffs demand judgment against defendant as follows:

Complaint and Jury Demand—Exhibit A, Claim for Refund

1. In the amount of $6,423.19 together with interest thereon from the date of such payments as provided by law.

2. All costs of this proceeding.

KENNETH T. STATMORE,
Attorney for the Plaintiffs.

Please take notice that the plaintiffs demand a trial of the issues of fact herein by a jury.

KENNETH T. STATMORE.

EXHIBIT "A".

Form 843 (Rev. Mar. 1960)

U. S. TREASURY DEPARTMENT, INTERNAL REVENUE SERVICE.

CLAIM

To be Filed with the District Director Where Assessment Was Made or Tax Paid

District Director's Stamp
(Date received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

Complaint and Jury Demand—Exhibit A, Claim for Refund

☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps Benjamin & Helen Stratmore

Number and street 441 Passaic Avenue

City, town, postal zone, State Passaic, New Jersey

Fill in applicable items—Attach letter size sheets if space is not sufficient

1. Social security number (H) 155-03-8483 (W) 143-12-7258

2. If an employer, enter employer identification number

3. District in which return (if any) was filed Newark, New Jersey

4. Name and address shown on return, if different from above

5. Period—if for tax reported on annual basis, prepare separate form for each taxable year From January 1, 1959 to December 31, 1959

6. Kind of tax Income

7. Amount of assessment $8,761.03 Dates of payment Various

8. Date stamps were purchased from Government

9. Amount to be refunded $5,904.61

10. Amount to be abated (not applicable to income, estate, or gift taxes) $

11. The claimant believes that this claim should be allowed for the following reasons: (Note Form 872 filed for 1959—period extended to June 30, 1964). The taxpayers on original return filed claimed a non-Business bad debt deduction of $1,000. for payment in 1959 in the total amount of $17,088.10 that resulted from the guarantee and borrowings on behalf of Corporations owned by the taxpayers their family. The taxpayer hereby amends their 1959 return and claim a deduction of $17,088.10 for the amounts pursuant to Section 165C(2) of the 1954 Internal Revenue Code. A Computation of the refund is shown on the attached sheet.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed .....

Dated ..... 19.... .....

Complaint and Jury Demand—Exhibit A, Claim for Refund

INSTRUCTIONS

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, enter social security and employer identification number, if any, of both husband and wife and each must sign this claim even though only one had income.

3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

6. If claim is for excess social security (F. I. C. A.) tax withheld as a result of having had more than one employer, include the names and addresses of your employers, and the amount of wages received and taxes withheld by each as part of your explanation in item 11. Do not claim tax withheld if you have claimed the excess withholding on your individual income tax return.

BENJAMIN AND HELEN STRATMORE
441 Passaic Ave., Passaic, N. J.
Form 843—Calendar Year 1959

	Original Return Filed	Amended Return
Computation of Refund:		
Income:		
Wages	$14,562.50	$14,562.50
Other Income	22,143.12	22,143.12
Income from rents	1,600.00	1,600.00
Capital loss	(1,000.00)	—
Adjusted Gross Income	$37,305.62	$38,305.62
Deductions:		
Contributions	$ 963.00	$ 963.00
Interest	1,262.36	1,262.36
Taxes	2,721.48	2,721.48
Medical Expenses	845.94	815.94
Other Deductions:		
Losses pursuant to Section 165C(2) I. R. C. 1954:		

Payments as guarantor & endorser of corporate obligations.		
Sheldon Pontiac		$ 2,400.00
Joseph A. Feder		2,078.00
Main Investment		110.10
Althols		3,500.00
R. Goldstein		2,700.00
J. Welsh		6,300.00
Total Deductions:	$ 5,792.78	$22,850.88
	$31,512.84	$15,454.74
Exemptions:	3,000.00	3,000.00
Taxable Income:	$28,512.84	$12,454.74
Total Tax:	$ 8,761.03	$ 2,856.42
	2,856.42	
Amount of Refund:	$ 5,904.61	

[Caption Omitted.]

ANSWER.

Comes now the defendant, United States of America, by its attorney, David M. Satz, Jr., United States Attorney for the District of New Jersey, and answers as follows:

1. Admits the allegations contained in paragraph 1 of the complaint.

Answer

2. Admits the allegations contained in paragraph 2 of the complaint, except denies that any taxes were paid in error by plaintiffs or illegally collected by the District Director.

3. Presently lacks sufficient knowledge or information to ascertain the truth or falsity of the allegations contained in paragraph 3 of the complaint.

4. Presently lacks sufficient knowledge or information to ascertain the truth or falsity of the allegations contained in paragraph 4 of the complaint.

5. Presently lacks sufficient knowledge or information to ascertain the truth or falsity of the allegations contained in paragraph 5 of the complaint.

6. Admits the allegations contained in paragraph 6 of the complaint.

7. Denies the allegations contained in paragraph 7 of the complaint, but admits that plaintiffs filed a claim for refund on March 2, 1964, a copy of which is attached to the complaint. Defendant specifically denies each and every allegation contained in said claim for refund which is not specifically admitted herein.

8. Admits that plaintiffs' claim is based on the stated premise, but denies that plaintiffs are entitled to recover on any basis.

9. Presently lacks sufficient knowledge or information to ascertain the truth or falsity of the allegations contained in paragraph 9 of the complaint.

Pretrial Conference

WHEREFORE, defendant, having fully answered, prays that plaintiffs' complaint be dismissed with prejudice, that judgment be entered in its favor that it be awarded its costs herein, and for such other relief as to the Court may seem just and proper.

.....
United States Attorney.

Defendant respectfully demands trial by jury.

.....

PRETRIAL CONFERENCE.

Newark, N. J.
Sept. 27, 1966.

Before: THE HONORABLE ANTHONY T. AUGELLI,
U. S. D. J.

APPEARANCES:
KENNETH T. STATMORE, Attorney for the Plaintiffs.
JOHN MILANO, Trial Attorney, Dept. of Justice.

Pretrial Conference

This is an action for refund of income taxes paid for the year 1959. This Court has jurisdiction under Section 1346 (a) (1) of Title 28 of the United States Code.

The factual contentions of the plaintiffs are set forth in the memorandum annexed hereto and made part hereof.

The factual contentions of the defendant are set forth in the memorandum annexed hereto and made part hereof.

The parties agree to file with the Court a joint stipulation of facts and annexed thereto and made part thereof will be the relevant exhibits. This will eliminate the necessity of a jury trial and it is hereby ordered that this case be transferred from the jury to the court's next non-jury trial calendar. Counsel are directed to file the stipulation with the Clerk of the Court on or before December 15, 1966.

Plaintiffs seek a refund of $6,423.19 paid as income tax, plus interest, and interest penalties for the calendar year 1959, plus statutory interest.

No amendments to the pleadings are being made by the parties.

With respect to legal issues, as set forth by the plaintiffs they are whether the payments made by the plaintiffs to certain creditors give rise to deductions for losses incurred in a transaction entered into for profit though not connected with a trade or business under Section 165 (c) (2) of the Internal Revenue Code of 1954; in the alternative, plaintiffs contend that if the District Director of Internal Revenue properly determined that plaintiffs' losses upon the payments made to said creditors constituted bad debts, then such bad debts are deductible as ordinary losses as business bad debts incurred in plaintiffs' trade or business.

As set forth by the government the legal issues are whether or not the plaintiffs are entitled to a deduction under Section 165 (c) (2) of the Internal Revenue Code of

1954 as a result of losses on a payment of certain corporate obligations which the plaintiffs became obliged to pay as a result of their prior guarantees of corporate obligations, or whether the plaintiffs are limited to a deduction of $1,000 as a short term capital loss under the provisions of Section 1211 (b) of the 1954 Internal Revenue Code; in the alternative whether payments by the taxpayers constituted contributions to the capital of the corporation resulting in an increase in their basis in their stock in such corporations, limiting their allowable losses to deductions upon the worthlessness of such stock.

No legal issues or defenses are abandoned by the parties.

Relevant exhibits will be filed with and made part of the stipulation heretofore mentioned in this pretrial order.

No additional discovery is indicated at this time.

No pretrial motions are in contemplation.

No expert witnesses.

Estimated trial time: one day.

Counsel are directed to submit trial briefs not later than ten days in advance of the trial date.

This transcript shall constitute the pretrial order in this case.

.....

U. S. D. J.

PRE-TRIAL MEMORANDUM.

Plaintiffs, by their attorney, Kenneth T. Statmore, herewith submit the following:

1. Benjamin A. Stratmore and Helen Stratmore, his wife, have instituted suit for refund of moneys alleged by plain-

tiffs to have been paid in error and illegally collected by the District Director of Internal Revenue for the District of New Jersey at Newark, New Jersey as income taxes for the calendar year 1959.

This Court has original jurisdiction under Section 1340 of Title 28 of the United States Code and Section 7402 of the Internal Revenue Code of 1954.

2. The factual contentions of the plaintiffs are set forth in the memorandum attached hereto and made a part hereof.

3. The plaintiffs hereby agree to stipulate the following facts:

a. In 1959 Benjamin A. Stratmore was president and a twenty-five per cent stock holder of B. B. Rider Corporation and General Manufacturing Corp., both New Jersey corporations with principal offices at 1094 Main Avenue, Clifton, New Jersey.

b. In 1959 Helen Stratmore was an officer and a twenty-five per cent stock holder of said B. B. Rider Corporation and General Manufacturing Corp.

* * * * * * * * *

STIPULATIONS OF FACT.

(Original Filed December 15, 1966.)

It is hereby stipulated and agreed by and between the respective parties hereto as follows:

Stipulations of Fact

1. The plaintiffs are husband and wife presently residing at Passaic, New Jersey. They timely filed their joint Federal income tax return for calendar year 1959 with the District Director of Internal Revenue at Newark, New Jersey.

2. Plaintiffs were officers and stockholders of B. B. Rider Corporation and General Manufacturing Corp., both New Jersey corporations, in 1959 and prior thereto.

3. Plaintiffs acquired an interest in B. B. Rider Corporation in 1938 and were instrumental in forming General Manufacturing Corp. in 1950.

4. General Manufacturing Corp. began operations by borrowing $50,000.00 from B. B. Rider Corporation. B. B. Rider Corporation had to borrow that sum from certain individuals who would not lend the money directly to General Manufacturing Corp. in view of the fact that it was nothing more than a corporate shell at the time of its incorporation without assets.

5. Benjamin A. Stratmore was and still is President of both corporations. His primary duties during the past fifteen years have been to secure financing for these corporations to meet their operational needs.

6. B. B. Rider Corporation is an authorized General Motors Frigidaire dealership which sells and services Frigidaire products in northern New Jersey. Its needs for capital are fixed and vary little, if at all. It operates on a cash on completion basis. General Manufacturing Corp. was formed in 1950 and manufactures precision component parts for aircraft engines for major engine manufacturers and

certain agencies of the United States government. General Manufacturing Corp. has varying needs for large amounts of working capital because of expensive material outlays and the long lead time between fabrication of the parts and payment from its customers.

7. General Manufacturing Corp. began operating with a capitalization of $50,000.00. However, because of unforeseen problems and delays, the capital requirements became greater than anticipated. Therefore, Benjamin A. Stratmore, of necessity, had to seek additional financing for General Manufacturing Corp.

8. After exhausting its credit with banking institutions, Mr. Stratmore was compelled to borrow monies for these corporations from certain individuals. These individuals would ordinarily loan monies to either of said corporations but, as security for said loans to the corporations, would require personal guarantees by way of indorsements on promissory notes of said corporations. Plaintiffs indorsed said notes of the corporations. Without the personal indorsements of the plaintiffs, Benjamin A. Stratmore could not have secured these loans and the corporations would have ceased functioning.

9. Plaintiffs gave their indorsements and lent their credit to B. B. Rider Corporation and General Manufacturing Corp. with the expectation that said corporations' use of these funds would provide them with increased receipts by way of salary and inhance the value of their proprietary interests in said corporations.

Stipulations of Fact

10. In August, 1957, B. B. Rider Corporation and General Manufacturing Corp. filed voluntary petitions in bankruptcy seeking reorganization under Chapter XI.

11. A plan of payment was agreed upon by a majority of the creditors of said corporations whereby only twenty-five per cent (25%) of the obligations due these creditors was to be paid. Said corporations were discharged from bankruptcy in December, 1958 having successfully completed the Arrangement under Chapter XI.

12. Certain creditors including Sheldon Pontiac (Sheldon Shiffman), Main Investment Company (David Shiffman), Joseph A. Feder, Robert Goldstein and John Welsh sought payment of the remainder due them by said corporations from the guarantors of the corporate notes, viz. the plaintiffs.

13. In an effort to cut their losses, the plaintiffs entered into certain agreements, both written and oral, with the aforesaid creditors whereby they agreed to pay part of the debt owed on said corporate notes in full settlement of their obligations as guarantors. Copies of the written agreements are annexed hereto and made a part hereof.

14. In order to effectuate a plan of reorganization the creditors insisted that the plaintiffs not file any claims against said corporations in the Chapter XI proceedings. The logic, of course, being that payment of the plaintiffs' claims would further deplete the assets of the estate. Plaintiffs did not file any claims in the Chapter XI proceedings.

15. Plaintiffs paid the following creditors in 1959 under the aforementioned agreements:

(a) Sheldon Pontiac	$2,400.00
(b) Joseph A. Feder	2,078.00
(c) Main Investment Company	110.00
(d) Samuel and Sadie Altholz	3,500.00
(e) Robert Goldstein	2,700.00
(f) John Welsh	6,300.00
Total	$17,088.00

Plaintiffs deducted said amounts on the original Federal income tax return that was filed for 1959 as non-business bad debts. However, the plaintiffs subsequently filed an amended return claiming said sums were entirely deductible under section 165(c)(2) of the Internal Revenue Code of 1954.

16. Plaintiffs paid their income taxes for calendar year 1959 to the District Director of Internal Revenue at Newark, New Jersey in installments. The final installment was paid in January, 1964. Said taxes totaled $5,904.61 plus interest and penalties in the sum of $518.58 or $6,423.19, the amount claimed in this suit for refund.

17. Plaintiffs filed a claim for refund and then filed an amended claim for refund on February 26, 1964 in the amount of $6,423.19.

18. More than six months elapsed after submission of said claim before plaintiffs instituted this suit for refund.

Respectfully submitted,

KENNETH T. STATMORE,
Attorney for Plaintiffs.
DAVID M. SATZ, JR.,
United States Attorney,
By: JOHN MILANO,
Assistant United States Attorney.

OPINION.

APPEARANCES:

For plaintiffs, KENNETH T. STRATMORE.

For defendant, MITCHELL ROGOVIN, Assistant Attorney General, by: DAVID A. WILSON, JR., ROBERT F. SAMA, JOHN G. MILANO, Attorneys, Department of Justice; and

DAVID M. SATZ, JR., United States Attorney, by: KENNETH P. ZAUBER, and MARTIN TUMAN, Assistant United States Attorneys.

AUGELLI, Chief Judge:

Plaintiffs, husband and wife, bring this action for a refund of income taxes for the year 1959, alleged by them to have been paid in error and illegally collected by defendant through the office of the District Director of Internal Revenue for the District of New Jersey. The jurisdiction of the Court is invoked under 28 U. S. C. A. §1346(a)(1).

The facts have been stipulated and are as follows:

Plaintiffs were officers and stockholders of B. B. Rider Corporation (Rider) and General Manufacturing Corporation (General) in 1959 and prior thereto. They acquired an interest in Rider in 1938, and were instrumental in forming General in 1950.

Rider is an authorized General Motors Frigidaire dealership which sells and services Frigidaire products in northern New Jersey. Its needs for capital are fixed and vary little, if at all. It operates on a cash on completion basis.

General is engaged in the business of manufacturing precision component parts for aircraft engines for major engine manufacturers and certain agencies of the United States Government. General has varying needs for large amounts of working capital because of expensive material outlays and the long lead time between fabrication of the parts and payment from its customers. It began operating with a capitalization of $50,000.00. However, because of unforeseen problems and delays, the capital requirements became greater than anticipated.

Plaintiff Benjamin A. Stratmore was and still is president of both Rider and General. His primary duties during the past 15 years have been to secure financing for these corporations to meet their operational needs. After exhausting bank credit, Stratmore was compelled to borrow money for both corporations from a number of individuals. These persons would ordinarily loan money to either Rider or General, but as security therefor would require personal guarantees by way of indorsements on promissory notes of the corporations. Plaintiffs complied with this requirement when the loans were made and indorsed the notes of said corporations. Without the personal indorsements of plaintiffs, these loans could not have been obtained and the corporations would have ceased to function. Plaintiffs gave their indorsements and lent their credit to Rider and General with the expectation that the use of these funds by the corporations would provide them with increased receipts by way of salary, and also enhance the value of their proprietary interests therein.

In August, 1957, both Rider and General filed voluntary petitions in bankruptcy under Chapter XI of the Bankruptcy Act. A plan was agreed upon whereby creditors of the corporations were to be paid 25% of the amounts due

them. As part of the plan, plaintiffs did not file any claims against the corporations in the Chapter XI proceedings. The arrangement was successfully completed, and Rider and General were discharged from bankruptcy in December, 1958.

Some creditors, however, who held promissory notes of Rider and General that had been indorsed by plaintiffs, sought payment of the balance due thereon from plaintiffs by reason of their indorsements of the notes. In an effort to cut their losses, plaintiffs entered into agreements with said creditors whereby plaintiffs agreed to pay part of the debt owed on said corporate notes in full settlement of their obligations as indorsers or guarantors thereof. In 1959, after the corporations had been discharged from bankruptcy, plaintiffs paid these creditors, pursuant to said agreements, a total of $17,088.00.

In their income tax return for 1959, plaintiffs treated the $17,088.00 so paid to creditors as a nonbusiness bad debt under 26 U. S. C. A. §166(d). As such, deductibility was limited to $1,000.00. On this basis, plaintiffs paid an income tax of $5,904.61, plus interest penalties of $518.58, or a total of $6,423.19. Thereafter, plaintiffs filed an amended income tax return in which they claimed, as fully deductible under 26 U. S. C. A. §165 (c)(2), the sum of $17,088.00. A claim for refund was then filed for the taxes and interest paid. No action having been taken on said claim for more than six months after submission, plaintiffs brought this action for refund.

In support of their claim for refund in this Court, plaintiffs contend that the $17,088.00 which they paid as guarantors of the promissory notes of Rider and General was either a loss incurred in a transaction entered into for profit, though not connected with a trade or business, under 26

U. S. C. A. §165(c)(2), or, alternatively, a business bad debt incurred in a trade or business, under U. S. C. A. §165(c)(1). Defendant, on the other hand, contends that the payments made by plaintiffs on their guarantees of the corporate notes constitute contributions to capital of the corporations or, in the alternative, that said payments constitute nonbusiness bad debts under 26 U. S. C. A. §166(d).

Plaintiffs' contention that their loss of $17,088.00 is fully deductible under 26 U. S. C. A. §165(c)(2) because it was incurred in a transaction entered into for profit, though not connected with a trade or business, cannot be sustained. The Chapter XI proceedings and plaintiffs' settlement on their guarantees resulted in a full discharge of the corporate obligations of Rider and General. Thus, the guarantors became subrogated to a worthless debt. A loss sustained by a guarantor unable to recover from his debtor is, by its very nature, a loss from the worthlessness of a debt, and there is no basis to consider it as an ordinary nonbusiness loss sustained in a transaction entered into for profit. PUTNAM v. COMMISSIONER, 352 U. S. 82 (1956).

Consideration will now be given to plaintiffs' alternative contention that the $17,088.00 was a business bad debt incurred in a trade or business, and hence fully deductible under 26 U. S. C. A. §165(c)(1). A business bad debt must arise in connection with the taxpayer's trade or business. WHIPPLE v. UNITED STATES, 373 U. S. 193 (1963). In that case a majority stockholder-officer loaned funds to his corporation and later claimed them as business bad debts. The Court held that "[a]bsent substantial additional evidence, furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business * * * " If plaintiffs in the case at bar had acted as guaran-

tors solely to protect their investment, they could not claim a business bad debt loss. However, the stipulated facts establish that plaintiffs were motivated not only to protect their investments, but also to protect and increase their salaries as corporate officers. In WHIPPLE, the Court stated:

> "Nor need we consider or deal with those cases which hold that working as a corporate executive for a salary may be a trade or business. E.g., *Trent v. Commissioner*, 291 F. 2d 669 (C. A. 2d Cir.). Petitioner made no such claim in either the Tax Court or the Court of Appeals and, in any event, the contention would be groundless on this record since it was not shown that he has collected a salary * * * or that he was owed one. Moreover, there is no proof * * * that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee."

In TRENT v. COMMISSIONER, 291 F. 2d 669 (2 Cir. 1961), Trent made loans to a corporation of which he was an officer and minority stockholder. He was told that unless he made these loans, the business would have to shut down. Thereafter, the corporation sought to obtain additional loans from Trent. He refused to make further advances, and was fired. He then attempted to collect the loans he had made to the corporation, but was unable to do so because it was without funds. Trent deducted these loans in his income tax return as business bad debts under Section 166 of the Internal Revenue Code of 1954, 26 U. S. C. A. §166. The Commissioner disallowed the deduction, claiming that the debt was a nonbusiness debt under Section 166(d) of the Code. The Court of Appeals reversed,

holding that "loans made by an employee to his employer in order to retain his job are as much 'created * * * in connection with a taxpayer's trade or business' as loans by the employer to customers, suppliers, or employees in the interest of the business would surely be."

In COWDEN v. COMMISSIONER, 34 T. C. 819 (1960), the Tax Court upheld the business bad debt deduction of a minority stockholder-director of a corporation resulting from payments on a guaranty of a corporate obligation which had a proximate relationship to a business which the taxpayer and his associates regularly carried on under a management contract with the corporation. The Court stated:

> "The money borrowed by General American on notes guaranteed by petitioner was used to permit General American to expand its business capabilities. It was the reasonable expectation of the guarantors that as General American prospered, so they would reap increased profits under the management contract. Such a situation, it seems to us, clearly establishes a proximate relationship between guaranties of the notes and the business operations under the management contract."

In JAFFE v. COMMISSIONER, 26 TCM 1063 (1967), the Tax Court found the bad debts sustained by two stockholder-employees, who guaranteed loans to their wholly owned corporation, to be business bad debts and fully deductible under 26 U. S. C. A. §166(a) since the taxpayers were motivated by a purpose to protect their jobs. The Court said:

> "[I]t is now * * * clear that being an employee of the corporation may itself constitute a trade or business,

so that if the stockholder-employee's loan to his corporation is made in order to protect his job or is otherwise proximately related thereto, the resulting debt is not a 'nonbusiness' debt within section 166(d)."

In FITZPATRICK v. COMMISSIONER, 26 TCM 1 (1967), the taxpayer was a co-guarantor of corporate obligations of a corporation of which he was an employee and in which he was also an investor. In support of his claim for deductibility of the loans made to the corporation, the taxpayer contended he was carrying on the trade or business of rendering services for pay by virtue of his position as vice president of said corporation. The Commissioner had ruled that the taxpayer had incurred a nonbusiness bad debt. The Tax Court agreed with the taxpayer, and found that his dominant motive in acting as co-guarantor of the loans was to protect and maintain his employment; also, that the guaranty arose in connection with and was proximately related to the taxpayer's trade or business, i.e., that of rendering services for pay.

The TRENT, COWDEN, JAFFE and FITZPATRICK cases support plaintiffs' claim that their loss is fully deductible as a business bad debt. Rider and General would have ceased to function but for the loans obtained for said corporations by plaintiffs. And those loans would not have been made without plaintiffs' guaranty. A cessation of business by the corporations would have resulted in a loss of plaintiffs' salaried positions. It has been stipulated that plaintiffs gave their indorsements and lent their credit to Rider and General with the expectation that the use of the borrowed and guaranteed loans by the corporations would provide plaintiffs "with increased receipts by way of salary and enhance the value of their proprietary interests in said

corporations." Such motivation is sufficient under the cited cases.

Cases which deny deductibility of loans as business bad debts are all distinguishable on their facts. Examples are WEDDLE v. COMMISSIONER, 325 F. 2d 849 (2 Cir. 1963); KELLY v. PATTERSON, 331 F. 2d 753 (5 Cir. 1964); RIETZKE v. COMMISSIONER, 40 T. C. 443 (1963); MILLSAP v. COMMISSIONER, 46 T. C. 751 (1966).

In WEDDLE, the Tax Court found that the loans made by the taxpayer to her corporation were made in her role as a stockholder or investor, and that any benefit received by the taxpayer was indirect and insufficient to establish a proximate relation to her trade or business of being an employee. The Court of Appeals, however, expressed the view that the necessary proximate relation might be established even where the primary motivating cause for the loan having been made was from the standpoint of a stockholder-investor, if there was a significant secondary motivation related to the trade or business of being an employee.

In the KELLY case, it was likewise found that the loans were not deductible because not related to the trade or business of being an employee. The Court of Appeals recognized, however, that a determination of the issue as to whether or not a debt is so related "depends on the motivation of the taxpayer in making the loans which created the debt." In RIETZKE, the Tax Court was unable to conclude, on the basis of the record before it, that the taxpayer "was required to guarantee these loans in order to keep his job or to *maintain* his trade or business as an employee." The record in MILLSAP was found by the Tax Court not to contain any evidence to suggest that the taxpayer in that case "was significantly motivated in making the advances he did in order to protect his position as a salaried officer

[of his corporation]", or that the loans in question were necessary to keep the company in business.

The Court is satisfied, under the stipulated facts of this case, that the payments made by plaintiffs on their guarantees of the corporate promissory notes of Rider and General, constituted business bad debts under 26 U. S. C. A. §165(c)(1) which were incurred in plaintiffs' trade or business. Under the circumstances, plaintiffs were entitled to deduct the full amount thereof in their 1959 income tax return.

There is no merit to defendant's contention that the losses sustained by plaintiffs constituted contributions to capital of Rider and General. This argument is based on the fact that General was thinly capitalized. But then capitalization alone is not enough to cause courts to treat debts as equity. ROWAN v. UNITED STATES, 219 F. 2d 51 (5 Cir. 1955). The question is one of fact, and the totality of circumstances in each case must be considered before determining whether advances are debt or equity. DIAMOND BROS. COMPANY v. C. I. R., 322 F. 2d 725 (3 Cir. 1963); LUNDGREN v. C. I. R., 376 F. 2d 623 (9 Cir. 1967).

As appears from the stipulated facts, Rider was a going concern when plaintiffs acquired an interest in it in 1938. Rider continued as a viable business until the reorganization proceedings in 1957. Plaintiffs were instrumental in the formation of General in 1950. General commenced operations by borrowing $50,000.00 from Rider. The latter had to borrow that money from certain individuals who would not make the loan to General because it had no assets. This initial loan may or may not have been a contribution to General's capital. But that initial loan is not involved in this case. Plaintiffs are claiming losses only with respect to the $17,088.00 paid to the holders of the guaranteed

corporate notes in 1959. In determining whether advances qualify as debt, later advances can be separated from the initial investment. See HUFFSTUTLER v. COMMISSIONER, 12 TCM 1422 (1953).

It has been noted that after General commenced operations with its initial capitalization, the need for additional financing arose. Plaintiff Benjamin A. Stratmore, being the officer charged with the duty of securing financing for both Rider and General, induced certain individuals, who were in no way connected with either corporation, to lend them funds for their business operations. However, the needed funds were not obtainable without plaintiffs' guarantee. In connection with the plan approved under the Chapter XI proceedings, creditors received 25% of the obligations due them. Those certain creditors who held Rider and General notes indorsed by plaintiffs then sought payment of the balance due on said notes through enforcement of the guarantees. These creditors and plaintiffs entered into settlement agreements whereby the creditors accepted less than full payment and required plaintiffs not to file any claims against Rider and General in the bankruptcy proceedings.

The loans made to Rider and General on the guaranteed notes were fixed in amount, interest bearing, and were payable whether the corporate makers thereof operated profitably or at a loss. The holders of such notes had the right to share with general creditors in the event of insolvency of the corporations. Thus, the debts in question substantially meet the tests laid down in WANAMAKER v. COMMISSIONER, 139 F. 2d 644 (3 Cir. 1943), for determining whether advances are debts or equity. The stipulated facts clearly support the inference that the loans here involved were treated as debts by the creditors and the guarantors.

The facts of this case do not support defendant's contention that plaintiffs' losses constituted contributions to capital of the corporations. The Court concludes, for the reasons stated herein, that plaintiffs have suffered a business bad debt of $17,088.00, which is fully deductible in their 1959 income tax return.

This opinion shall constitute the Court's findings of fact and conclusions of law pursuant to Rule 52(a) of the Federal Rules of Civil Procedure. Counsel for plaintiffs, on notice to counsel for defendant, will please submit an appropriate order.

JUDGMENT.

The Court having considered the evidence and the arguments of counsel, and having entered its findings of fact and conclusions of law herein, it is in conformity therewith:

ORDERED, that plaintiff have judgment against defendant for the principal amount of $6,574.64, with interest thereon at six percent according to law.

DONE IN OPEN COURT at Newark, New Jersey, this ..... day of ....., 1968.

.....
United States District Judge.

Presented and approved by:

.....
Attorney for Plaintiff.

Approved as to form by:

.....
United States Attorney.

NOTICE OF APPEAL TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

(Original Filed February 4, 1969.)

NOTICE is hereby given that the United States of America hereby appeals to the United States Court of Appeals for the Third Circuit from the Judgment entered in this action on the 11th day of December, 1968.

DAVID M. SATZ, JR.,
United States Attorney,
By: s/ KENNETH P. ZAUBER,
Assistant United States Attorney.